# INDEX


| | Pages |
|---|---|
| Petition for Writ of Certiorari | 1 |
| Opinions Below | 2 |
| Jurisdiction | 2 |
| Questions Presented | 2 |
| Statutes | 3 |
| Statement | 3 |
| Reasons for Granting the Writ | 8 |
| Conflicts | 8 |
| Important Undecided Federal Question | 14 |
| Conclusion | 15 |
| Brief in Support of Petition for Writ of Certiorari | 17 |
| Opinions Below | 17 |
| Jurisdiction | 17 |
| Statutes Involved | 18 |
| Questions Presented | 18 |
| Statement | 19 |
| Specification of Errors to be Urged | 19 |
| Summary of Argument | 20 |
| Argument | 22 |
| Point I | 22-31 |
| Point II | 31-36 |
| Point III | 37-39 |
| Point IV | 40-44 |
| Point V | 44-46 |
| Conclusion | 46 |
| Appendix | 49 |
| A - Pertinent Statutes | 49-51 |
| B - Correlation of Regulations Dealing with Bonus Depletion | 53-54 |
| C - Dissenting Opinion of Circuit Judge Hutcheson in Crabb v. Commissioner | 55-60 |

## AUTHORITIES

Pages

**Cases:**

Anderson v. Helvering, 310 U. S. 404, 60 S. Ct. 952 ..... 34

Burnet v. Harmel, 237 U. S. 103, 53 S. Ct. 74 ..... 33
Burnet v. Sanford & Brooks Co., 282 U. S. 359 ..... 9, 32
Burnet v. Thompson Oil & Gas Co., 283 U. S. 301 ..... 10, 32

Crabb v. Commissioner, 41 B. T. A. 686 ..... 25, 40
Crabb v. Commissioner, 119 Fed. (2d) 772 ..... 6, 14, 29, 55
Creasey Corporation v. Helburn, 57 Fed. (2d) 204 ..... 39
Commissioner v. Speyer, 77 Fed. (2d) 824 ..... 39
Cooper v. Commissioner, 7 B. T. A. 798 ..... 26

Grauman's Greater Hollywood Theatre Inc., 37 B. T. A. 448 ..... 39
Guaranty Trust Company v. Commissioner, 303 U. S. 493 ..... 9, 32, 39

Helvering v. Bankline Oil Company, 303 U. S. 362, 56 S. Ct. 616 ..... 34
Helvering v. New York Trust Co., 292 U. S. 455, 468 ..... 23
Helvering v. Reynolds Tobacco Co., 306 U. S. 110 ..... 23
Helvering v. Schine Chain Theaters Inc., 121 Fed. (2d) 948 ..... 10, 39
Herring v. Commissioner, 293 U. S. 322 ..... 4, 12, 14, 22, 23, 44

Knapp v. Commissioner, 7 B. T. A. 790 ..... 26

Lamont v. Commissioner, 120 Fed. (2d) 996 ..... 14, 24, 30

Maryland Casualty Company v. United States, 251 U. S. 342 ..... 34, 35

Sugar Creek Mining Company, 31 B. T. A. 344 ..... 39

United States v. Kirby Lumber Co., 284 U. S. 1 ..... 11, 34

**Statutes:**

Revenue Act of 1926:
Sec. 204(c)(2) ..... 4, 49
Sec. 214(a)(9) ..... 4, 49

AUTHORITIES—Continued


| | Pages |
|---|---|
| **Revenue Act of 1932:** | |
| Sec. 113(b) | 39 |
| **Revenue Act of 1936:** | |
| Sec. 11 | 31 |
| Sec. 41 | 32 |
| Sec. 22 | 50 |
| Sec. 113(b)(1) | 50 |
| **Revenue Act of 1938:** | |
| Sec. 820 | 38 |
| **Internal Revenue Code:** | |
| Sec. 3801 | 38 |
| **Treasury Regulations and Rulings:** | |
| **Regulations 45:** | |
| Art. 214(a) | 42 |
| Art. 215 | 57 |
| Art. 220(a) | 41 |
| **Regulations 62:** | |
| Art. 201(c) | 41, 42 |
| Art. 214 | 41, 42 |
| Art. 220(a)(3) | 41, 42 |
| Art. 215(d) | 25, 27 |
| **Regulations 65:** | |
| Art. 216(d) | 41 |
| Art. 215 | 42 |
| **Regulations 69:** | |
| Art. 201 | 24 |
| Art. 216(d) | 22, 52 |
| Art. 216(e) | 27 |
| Art. 221 | 42 |
| **Regulations 74:** | |
| Art. 221 | 42 |
| **Regulations 94:** | |
| Art. 23(m)-10(c) | 22 |

AUTHORITIES—Continued

Pages

Regulations 103:
Sec. 19.23(m)-2 ..... 24

C. B.-2, 1940-2 ..... 25

G. C. M. 14,448, C. B. XIV-1, p. 98 ..... 22, 25

**Other Authorities:**

Paul & Mertens Law of Federal Taxation, Para. 11.03, p. 481 ..... 39

Senate Finance Committee Report (69th Cong. 1st Sess. S. Rep. 52) ..... 27

Ways & Means Committee Report (69th Cong. 1st Sess. H. Rep. 1) ..... 27

NO._____

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1941.

TERRY THOMPSON, ET AL., INDEPENDENT EXECUTORS OF THE ESTATE OF J. T. SNEED, JR., DECEASED,

*Petitioners,*

vs.

GUY HELVERING, COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

**Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.**

Terry Thompson, Elizabeth Sneed Pool, L. G. Haile and H. C. Pipkin, Independent Executors of the Estate of J. T. Sneed, Jr., Deceased, pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above entitled cause on May 5, 1941, affirming a decision of the United States Board of Tax Appeals.

## OPINIONS BELOW

The original opinion of the Circuit Court of Appeals (R. 86) is reported at 119 Fed. (2d) 767. It was amplified in an opinion on Motion for Rehearing (R. 104), reported in 121 Fed. (2d) 725. The opinion of the Board of Tax Appeals is reported in 40 B. T. A. 1136.

## JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 5, 1941. (R. 95.) Petitioners' Motion for Rehearing, seasonably filed, was denied on July 17, 1941. (R. 106.) The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTIONS PRESENTED

Can a portion of certain sums which Petitioners' decedent (Sneed) received in *1926*,[1] and of which he then and thereafter had unqualified ownership and possession, without obligation or liability to anyone, be treated as a part of his taxable income in *1936*, even if:

(a) The total sums received in *1926* were paid to Sneed as bonuses for various oil and gas leases which he made in that year on various portions of a ranch owned by him;

(b) He obtained in *1926* an allowance for percentage depletion with respect to all of these bonuses;

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[1]Emphasis supplied throughout unless otherwise noted.

(c) Certain of these leases lapsed in *1936* without development upon the areas covered by the lapsed leases although the substantial mineral reserves underlying the lapsed-lease areas had been partially depleted by production from other wells on the ranch from which Sneed received royalty income; and

(d) The sum included in *1936* income represented the percentage depletion allowed with respect to the bonuses received in *1926* for the leases which so lapsed?

## STATUTES

The pertinent statutes appear in the appendix.[2]

## STATEMENT

Sneed owned a ranch in Moore County, Texas. (R. 44). Developments subsequent to his acquisition definitely established that the entire ranch was underlain with one continuous, highly productive gas stratum, and less regular oil deposits. (R. 25, 44, 49, 51.) Sneed made numerous commercial oil and gas leases on areas out of the ranch so that, by the end of 1926, it was all under lease (R. 45). All leases involved here were for a primary term of ten years and for so long thereafter as oil or gas was produced, with the customary royalties to the lessor. (R. 45.) Sneed received a cash bonus for each lease made. (R. 49.) These bonuses became Sneed's property, unconditionally and without liability or obligation to anyone, when he received them in 1926. (Cf. typical lease, R. 75.)

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[2]See pp. 49 to 51, infra.

Sneed reported the bonuses received in 1926 as a part of his gross income for that year. (R. 27.) He claimed, and ultimately obtained,[3] (30 B. T. A. 1121; 33 B. T. A. 478) allowances for depletion with respect to such bonuses upon the percentage of income basis.[4] (R. 25, 74.)

Between 1926 and 1936 extensive development was carried on by several of Sneed's lessees with the result that substantial quantities of oil and more than forty billion cubic feet of gas were produced and marketed from the ranch, Sneed receiving and reporting his ordinary royalties thereon. (R. 49, 71.) However, no wells were drilled upon twenty-six of the leased areas during the ten year primary term, so that these twenty-six leases lapsed in 1936. (R. 74.) Sneed made new leases upon the lapsed areas to other operators, receiving therefor cash bonuses which were reported as a part of his gross income. (R. 27, 74.) He claimed and was allowed percentage depletion with respect to these new bonuses. (R. 27, 74.)

The development and production during this ten year period demonstrated with absolute certainty, (and the Board found)[5] that every part of the ranch was originally underlain with a continuous gas stratum (R. 59, 62); that this gas content had been depleted through production (R. 59, 64); this depletion had resulted to a large extent from production through wells

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[3]In accordance with Herring v. Commissioner, 293 U. S. 322, decided while his appeal was pending.

[4]Sec. 214(a)(9) and Sec. 204(c)(2) of the Revenue Act of 1926. (R. 74.)

[5](R. 26, 27).

on other parts of the ranch from which Sneed had received, and reported for taxation, royalties (R. 26, 27, 71, 74); that the pressure or gas in the stratum underlying the entire ranch dropped during this ten year period from 430 pounds per square inch to a low of 280 pounds (R. 56, 57); the depletion on the twenty-six lapsed areas averaged 11% of the original reserves, varying from 2.7% to 28.9% (R. 58, 62); but this left ample reserves for commercial production under each of these twenty-six areas *which would be subsequently produced.* (R. 27, 59.)

Upon auditing Sneed's 1936 return, the Respondent determined that $38,720.62 (the amount allowed as depletion in 1926 with respect to the bonuses paid for the leases which lapsed in 1936) should be included in his income for 1936 as "restored depletion." (R. 14.)[6]

The basic theory of decision in the Court below was that the 1926 depletion allowances represented untaxed gross income received in 1926; that these allowances were made upon condition that, if the lessor's property was not subsequently depleted, the allowances were to be restored to income; and that, since the statute of limitations prevented correction being made in 1926, it was proper to treat the "untaxed income" as income for the year in which it was established that no depletion had been actually sustained by the lessor. (R. 89-94.) In determining whether there had been actual depletion within this ruling, the Court held that neither the actual depletion which Sneed's ranch prop-

[6]This amount was adjusted by stipulation to $33,528.07, but this correction has no bearing upon the issue presented here.

erty as a whole admittedly sustained during this ten year period, the reduction in reserves under each of the twenty-six areas occasioned primarily through production elsewhere on the ranch, nor the established fact that each of the twenty-six areas would actually produce subsequent to 1936, had any bearing upon the question. (R. 89-94.) Instead, the holding was that, in ascertaining whether actual depletion had been sustained, for the purpose of applying its rule, the Court would look only to the precise area covered by a particular lease, and would require that the depletion of that area occur through production from a well drilled on that area, during the term of that lease, regardless of the certainty of future production from, and depletion of, that precise area. (R. 88-92.)

The decision below was unanimous. (R. 86, 94.) But in a case[7] involving the same question, submitted at the same series of hearings, Judge Hutcheson, who did not sit in the Sneed case, filed a forceful dissenting opinion in which he stressed particularly the unfairness of the majority rule in its application to various lessor-lessee situations which frequently arise and in which he vigorously disagreed with the construction which the majority placed upon the Treasury Regulations.[8] For convenience, this dissenting opinion is reproduced in the appendix, infra, pages 55-60.

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[7]Crabb v. Commissioner, 119 Fed. (2d) 772, (5th C. C. A.).

[8]These regulations are set out and discussed in the accompanying brief at p. 25, infra.

## SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that Sneed received income in 1936 in an amount equal to the 1926 allowances for percentage depletion, when oil and gas leases made in 1926 lapsed without production from the leased areas.

(2) In holding that taxing such amount as 1936 income was not contrary to the constitutional and statutory provisions defining income and requiring the calculation of taxable income upon an annual basis.

(3) In holding that Sneed took the 1926 depletion allowances upon condition that they be restored to income when and if it was determined that there would be no production from the particular lease for which the bonus was paid.

(4) In holding, in view of the undisputed fact that the gas reserves in each of the areas covered by the twenty-six leases had been actually depleted, that the amount of the 1926 depletion allowances should be included in Sneed's income in 1936.

(5) In holding, it being conclusively established that there would be production subsequent to 1936 from the twenty-six areas and the 1926 bonuses having been "income from the property," that the 1926 depletion allowances should be restored to income in 1936.

(6) In refusing to hold that Sneed's entire ranch was one "property," in applying the principle that bonus depletion allowances cannot be restored if the "property" has been depleted during the life of the lease.

## REASONS FOR GRANTING THE WRIT

The writ should be granted because the basic holding of the Court below conflicts with controlling decisions of this Court and an applicable decision of the Second Circuit Court of Appeals; and because the Court below decided an important question of federal law which has not been, but which should be decided by this Court.

## CONFLICTS

### I.

The Court below said, in summation of the holding upon which the Petitioners base their claim of conflict:[9]

> "*But where the return is correct on the facts as they were when it was made, but occurrences in a later year alter the case, the adjustment is generally to be made in the latter year.* This does substantial justice, gives more stability to the annual tax settlements, escapes the complication of limitation statutes, and serves administrative convenience. This case comes within the latter rule."

This holding, the heart of the case, that the amount of an error made ten years previous became income in the year that the error was established, without the receipt or accrual in that year of anything and without the reduction of any liability, directly conflicts with

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[9]Here we assume, arguendo, that the Court below correctly held that the 1926 depletion allowances were improper, but we confidently assert and attempt to show in the attached brief, that these allowances were properly made.

the holdings of this Court and of other Circuit Courts of Appeal.

In *Guaranty Trust Company v. Commissioner*, 303 U. S. 493, this Court said (page 498):

> "Receipt of income, or accrual of the right to receive it within the tax year, is the test of taxability, * * *."

The Court below admitted, as everyone who examines the record must, that nothing was received by or accrued to Sneed in 1936. The fact that the leases terminated in *1936* does not bring Sneed's case within the rule of *Guaranty Trust Company v. Commissioner*, *supra*. The Court below correctly said on this point:

> "It is not a good reply that Sneed got back the leasehold interest in the land in 1936. If that be the ground of income, the value in 1936 of what he got back would be in question. And in truth he got nothing back; the lease simply perished according to its original terms."

Other decisions of the Court hold that income and deductions must accrue or be received or paid within the tax year before they can enter into the calculation of the taxable income for that year. A typical case is *Burnet v. Sanford & Brooks Company*, 282 U. S. 359, where it was said (page 363):

> "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the

option of the taxpayer, the particular fiscal year which he may adopt. * * *."

In *Burnet v. Thompson Oil & Gas Company*, 283 U. S. 301, it was said, at page 306:

> "The tax is an income tax for 1918, and in the absence of *express provision to the contrary*,[10] it is not to be supposed that the taxpayer is authorized to deduct from that year's income, depreciation, depletion, business losses, or other similar items attributable to other years."

A recent decision by the Second Circuit Court of Appeals, *Helvering v. Schine Chain Theatres, Inc.*, 121 Fed. (2d) 948, decided July 21, 1941, with which the decision below conflicts, is particularly pertinent because the Second Circuit case dealt with prepaid rentals for building leases which were not even reported as income in the year when they were received by the lessor for his unqualified use and disposition. For one such long term lease the lessor in 1929 received an initial payment of $440,753.46, no part of which was "under any circumstances (to) be returned to the tenant notwithstanding any termination of this lease for any reason whatsoever prior to the expiration by lapse of the term hereof."[11] The lessor reported in 1929 only an aliquot portion of the cash payment based upon the possible life of the lease, and followed the same practice through 1933. In 1933 the lease was cancelled in an insolvency proceeding. The Commissioner attempted to add to the lessor's 1933 income the unre-

[10]There are no such provisions applicable here.

[11]This is the exact situation as to all of the lease bonuses here involved.

ported balance of the initial payment. The Second Circuit Court of Appeals refused to permit this. After stating that:

> "* * * everyone now agrees that the payments in question were in fact income only in the year 1929 when they were received. The time had passed in 1933 to assess a deficiency for that year, and unless the Commissioner can succeed upon some theory of 'estoppel,' the unfortunate fact is that a very large sum will escape taxation."

the Court then held that, under the circumstances,[12] the taxpayer was not estopped to assert that funds which it had received, without limitation or liability in 1929, could not be taxed as income for 1933.

Under the opinion in the Court below, the question of estoppel would never have been reached. That Court would have taxed the item when "occurrences in a later year (had) alter(ed) the case." The bases of the two decisions thus fundamentally conflict.

All of the above is said in full recognition of the principle that taxable income can sometimes accrue when there is no actual receipt within the tax year, but there is a realization of an enhancement in wealth. *United States v. Kirby Lumber Company*, 284 U. S. 1, is such a case. There the Lumber Company's bonds were bought in and retired for less than the issuing price. In that case, liabilities were reduced and assets were freed from the charge theretofore against them. Somewhat similar situations arise when a bad debt

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[12]The controlling point on estoppel was that there was a disclosure, without misrepresentation, of all pertinent facts.

previously charged off is collected, an operating expense or tax previously considered in calculating taxable income is reduced, recouped or avoided, or reserves freed from an offsetting liability. In all of these cases there is either an actual receipt in the tax year or a reduction in an actual liability. Not one of these elements is present in this case. The bonus money became Sneed's, unqualifiedly, in 1926. He had no liability to anyone with respect to it. He received nothing in 1936, nothing then accrued to him, he was freed from no liability. There was nothing to meet this Court's requirement that receipt or accrual of income within the tax year "is the test of liability."

II.

The decision below conflicts with *Herring v. Commissioner*, 293 U. S. 322. The Herring case recognized and held, in substance, that the depletion section of taxing statutes grant to everyone having an economic interest in an oil and gas property the right to recover, through annual deductions from income, his basis for the property. The basis, when percentage depletion is applicable, is 27½ per cent of the taxpayer's gross income from the property, limited in each year to 50% of his net income therefrom. In the *Herring* case this Court held that a lessor, whose situation was identical with Sneed's, was entitled to a percentage depletion allowance with respect to bonuses received in that tax year, even though there had not then been, and might never be, any production from the property or any actual depletion of the lessor's interest therein. The reason for this was that the allowance could be made only

in the year that gross income (lease bonuses or advance royalties) was received. If the allowance was not made then, the lessor could never recover that much of his basis, no matter how much the property might subsequently produce and be depleted.

In the case at bar Sneed received gross income from the property in 1936, for he then received cash bonuses for the new leases which he made upon the lapsed areas. It was found as a fact that he would receive further gross income from these very areas in subsequent years through development of, and production from, the gas deposits then known to be under these areas. (R. 26, 27.)

Under the *Herring* case it is not necessary that actual depletion occur in the year in which gross income is received and the depletion allowance is made. But it is necessary, if a lessor is to be allowed in the aggregate depletion allowances equal to 27½ per cent of his entire gross income from the property, that no part of an allowance previously made be included in income until and unless it is *certain* that there will never be any production. Therefore, the holding of the Court below, to the effect that the 1926 allowances could be included in 1936 income despite the fact that Sneed received in 1936 additional gross income from the property (the bonuses for new leases) and would receive further gross income through subsequent development under them, clearly conflicts with this Court's holding in the *Herring* case.

## IMPORTANT UNDECIDED FEDERAL QUESTION

In *Herring v. Commissioner*, 293 U. S. 322, after deciding that Herring was entitled to a depletion allowance on his cash bonuses, this Court said:

> "As to income tax liability in the year of termination of the lease, on account of bonuses paid on execution of the lease, if no mineral has been extracted, we express no opinion."

Since that decision, this Court has not passed upon any phase of the bonus depletion question. The precise question has not been before any Federal Appellate Court,[13] other than the Fifth Circuit Court of Appeals in this and the subsequently decided Crabb case.[14]

The practice of making oil and gas leases for a cash bonus is practically universal. The question involved here can arise whenever a cash bonus is paid for an oil and gas lease and subsequent operations under that lease fail to produce oil and gas. This happens very frequently. Many cases are pending in the Board and in the Bureau of Internal Revenue involving the identical question.[15]

Clearly the question is important as related to the taxation of income from minerals, and is even more

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[13]The case of Lamont v. Commissioner (C. C. A. 8, 1941), 120 Fed. (2d) 996, dealing with cost depletion allowed on minimum royalties, paid under hard mineral leases, is readily distinguishable. Cf. Brief p. 30, infra.

[14]Dolores Crabb et al. v. Commissioner (C. C. A. 5th, 1941), 119 Fed. (2d) 772; See also Brief p. 30, infra, and appendix, p. 55, infra.

[15]Only the Bureau of Internal Revenue can give accurate information as to the number of such cases.

important when the broader application of the decision is considered,—that is, when consideration is given to the importance of a holding that an amount can be taxed as income in a year in which nothing was received by or accrued to the taxpayer.

Importance of the question is emphasized by Judge Hutcheson's dissenting opinion in *Crabb v. Commissioner*, supra.

## CONCLUSION

Wherefore, it is respectfully submitted that this petition for certiorari should be granted.

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